

MEMO# 27970

March 24, 2014

Hong Kong SFC Issues Consultation on the Regulation of "Alternative Liquidity Pools"

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TO: EQUITY MARKETS ADVISORY COMMITTEE No. 5-14
INTERNATIONAL MEMBERS No. 7-14
ICI GLOBAL MEMBERS No. 8-14 RE: HONG KONG SFC ISSUES CONSULTATION ON THE REGULATION OF "ALTERNATIVE LIQUIDITY POOLS"

The Hong Kong Securities and Futures Commission (SFC) has issued a consultation [\[1\]](#) on the regulation of "alternative liquidity pools" (ALPs), i.e., alternative trading systems and dark pools. [\[2\]](#) In general, the consultation proposes to enhance and standardize obligations imposed on Hong Kong licensed corporations that operate ALPs by including within its Code of Conduct requirements governing their operation. The consultation states that the proposals draw on initiatives for the regulation of ALPs developed in other jurisdictions and reflects regulatory responses that it considers desirable within the context of the Hong Kong market.

The proposals cover several areas including, significantly, restricting access to ALPs to institutional investors. In restricting access in such a manner, the consultation recognizes that institutional investors can benefit from their trades being effected through ALPs. Specifically, the consultation states that the advanced technology utilized by ALP operators can serve to expand sources of liquidity, reduce transaction costs and mitigate market impact when large orders are executed, and ALPs often provide more flexible trading and execution mechanisms than those available on traditional exchanges. Nevertheless, the consultation states that the potential benefits to retail investors wishing to buy or sell relatively small numbers of securities is more open to question, citing concerns that the growth of ALPs could weaken the price discovery function that is typically provided by traditional stock exchanges and adversely affect the competitiveness of smaller broker-dealers.

The consultation further notes that global regulators have identified various potential issues to which the growth of ALPs might give rise under existing regulatory regimes. The consultation states that ALP operators which use technology and new business models to deliver services in an innovative manner might blur the line between the functions

traditionally performed by exchanges and those performed by market intermediaries such as broker-dealers. The consultation therefore proposes, and requests comment on, several measures that would enhance the level of disclosure to ALP users, ensure the priority of agency orders over proprietary orders initiated by ALP operators and their affiliates, limit the level of visibility of trading information available to the staff of ALP operators, maintain system adequacy, and introduce additional control, record keeping and reporting requirements.

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endnotes

[1] The consultation can be found on the SFC's website at <http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=14CP3>. Comments on the consultation are due to the SFC by April 25, 2014.

[2] According to the consultation, references to "ALPs" are intended to be "references to electronic systems through which the crossing or matching of orders is conducted anonymously without any pre-trade transparency, including systems designed and developed in-house or by third party service providers."

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